(Provisional translation)

The Sixth Meeting of the "Advisory Council on the Economic Value-based Solvency Framework"

1. Date and Time: December 20, 2019 (Friday) 1:00 p.m. to 2:40 p.m.
2. Venue: Special Conference Room No. 1, 12th Floor, Central Government Building No. 7
3. Minutes: Following a presentation by the secretariat, the discussions were held as below.

- The timeline on page 2 in Material 1 fits very well with what I had in my mind. As an important perspective for formulating a schedule going forward, consideration needs to be given to how to phase out regulations on the net real asset regulation and the mindset based on existing indicators, such as fundamental profit, which is not consistent with an economic value-based approach. It should be made clear that dialogue with insurers will be carried out regarding the areas outside of regulatory compliance. The topics may include the preparations for the introduction of an economic value-based regulation, and action plans of insurers to switch to different KPIs. This dialogue will make it easier for insurers as well to take necessary actions.

- There was the opinion that the MOCE should not be counted as a risk if it is deducted from net assets, which I think is a strange argument from the standpoint of market-consistent valuation. For example, when calculating the value of a corporate bond, in addition to the risk-free rates, spreads are also reflected when discounting expected future cash flows to account for the risks associated with it. In other words, it is normal to account for a value commensurate with the risk in the context of valuation, and evaluate the associated risk itself at the same time. I do not see it as double-counting from a market-consistent standpoint.

- I personally do not agree with using the percentile method for calculating MOCE. In the case of the cost-of-capital method, one year's worth of risk disappears after one year

passes and a return equivalent to the cost of capital will be obtained, if the expected scenario is actually realized. In that sense, it clearly shows the relationship between capital, risk and the ex post returns. Meanwhile, it is difficult to understand the rationale and the relationship between the risk and return under the percentile method. This is a technical issue, but it is best to sort this out in this meeting.

- There have been opinions in favor of conducting a symmetric risk adjustment (for equity risk), which I think could give rise to regulatory arbitrage. If such measure is introduced, it should be made clear that this is a policy measure with specific objectives, and should not be used in Pillar 2. There also needs to be careful discussion on whether it should be introduced into Pillar 1 in the first place.

- There is a considerable difference between the cost-of-capital method and the percentile method for MOCE calculations given that life insurers in Japan typically provide a substantial amount of long-term products, in contrast with insurers in other countries. The percentile method is actually employed in certain cases, including the cash flow testing framework in the US. Neither method is absolutely correct, but a settlement needs to be made. In Pillar 1, it would be an option to adopt the percentile method in accordance with the ICS. Even in that case, we need to ensure that the percentile method is not adopted unconditionally in insurers' risk management frameworks simply because it is adopted in the ICS. The cost-of-capital method is used in M&A deals, from the perspective of transfer value. We need to design a framework which allows insurers to adopt a methodology that is suited to their situation and objectives.

- It is a straightforward approach to determine risk factors for required capital based on calibration based on historical data. Meanwhile, attention must be paid to unknown knowns, such as global warming and advances in medical technology, for which we cannot observe historical performances. We should try to incorporate these risks to the framework in some way or other.

- The ICS is designed as a group-based standard. On the other hand, I understand that we are primarily concerned with solo-based regulation in this Council (although treatment

of insurance groups also needs to be discussed). Some differentiation between solo- and group-based rules is also introduced in Solvency II. We may come up with an additional methodology for assessing the risk of dependence on group companies.

- When the new regulation is introduced in 2025, there could be some impact on the market if all insurers embark on measures such as selling of equities and purchase of ultra-long-term bonds. I do not know if it is better to engage in a dialogue with insurers or introduce transitional measures, but I think we need to look at such unintended consequences in some way. As for the issue of procyclicality, I think it is necessary to deal with it while taking into account affinity with the current system, including contingency reserves and price fluctuation reserve, in addition to the symmetric adjustment mechanism.

- I welcome that the timeline is clarified on page 2 of Material 1 so that insurance companies can carry out preparations. On the other hand, I believe we need to adopt a common understanding that even if the new regulation is to be introduced in 2025, a review period of 2-3 years prior to adoption will need to be set to reconsider the framework, factoring in international developments. Another issue is that, although standards are set to be finalized in 2024, IT systems and other organizational capacities will not be ready in time if insurers initiate the preparation after that. It is thus important to clarify a period for consideration of these standards (regulations), as insurers will need to make decisions on organizational changes and large-scale investments well ahead in time.

- As a vision for 2025, there are two possibilities, one in which the ICS is adopted as a uniform standard, including in the US, and the other being the situation where rules in each jurisdiction are aggregated and connected through an equivalence framework. Perhaps it is essential to carry out discussions assuming the former. Once this Council clarifies what is necessary in the Japanese framework, we will need to work with the IAIS to ensure they are properly reflected in the ICS as well. Although it is true that the opinions from the industry were taken into account, there are many points to be reviewed in ICS Version 2.0.

- Regarding a standard model, on page 7 of Material 1, it states that it is also necessary to consider factors including the flexibility of supervisory intervention in Pillar 1. I am in agreement with this. Nevertheless, given that economic value-based indicators are to be disclosed, the modification of the rules for ESR calculation should be considered as far as possible, including adjustments based on certain policy objectives.

- In the ICS, the requirements for the middle bucket were relaxed to allow inclusion of items whose cash flow is matched only partially. However, its details are still unclear, including just how this will function and how much will be included in the middle bucket. In addition, equities are not likely to be treated as eligible assets in the middle and top buckets, as they do not have fixed cash flow. I believe they should, to a certain extent, be recognized as eligible assets, as they could be liquidated to match liability cash flow.

- If you view this from the standpoint of market consistent valuation, MOCE should indeed be included in the valuation of insurance liabilities. However, there could be a different perspective in terms of designing an overall regulatory framework. The industry has been raising a concern that risks would be double-counted if MOCE were included as liabilities. Discussions need to be carried out on the roles and function of MOCE. If not, then MOCE should be recognized as a margin, not a liability. In the percentile method of the ICS, regarding non-financial risks, the required capital should cover the 99.5% VaR (a once-in-200-year risk) measured over a 1-year horizon, and MOCE is designed to cover an 85% VaR (a once-in-6 to 7-year risk) measured over a 1-year horizon in the case of life insurers.

- As for the tax effect, it is my understanding that the recoverability assessment is quite conservative and it is an issue with a very significant impact on required capital. Regarding the tax effect of capital requirements, I think there is a lack of balance due to the excessively conservative treatment of the possibility of absorbing tax losses on required capital.

- The secretariat's materials compile timeline issues covered thus far in a very easy-to-understand manner. It is important here to note that the basis is the finalization of

standards (regulations) in 2024. Listening to the opinions from the industry, it seems appropriate to set the official start date for calculations at 2026, given that it will take approximately two years to develop IT systems. In conjunction with the field test that will be conducted through 2024, I think the supervisory college will be a good place for exchanging views. Furthermore, it is also important to educate consumers and market participants on new regulations to provide them with a deeper understanding and to make an effort to make these new regulations common knowledge. I also once again felt it is important to finalize the ICS, as scheduled, in 2024. International standards are not provided but are created by participation from everyone. Representatives of the Japanese authority should take a role of leadership at IAIS. I think it is very important for Japan and the rest of the world for the ICS to be completed by 2024.

- Since economic value-based regulations will eventually be introduced at some point, I feel that it is necessary to change the ICS rather than passively wait for it, from the standpoint of the industry. There are various opinions among insurance companies, but I would like to coordinate this into one voice and promote these opinions to the IAIS.

- The image of the timeline and corresponding tasks on the secretariat's material is very easy to understand. In examining Pillar 1, there are several key points: the theoretical validity of the computational logic, the feasibility of how to achieve this, and an impact study on the impact of implementation. Unfortunately, as there is no statement on the impact study, I think it would be better to include a clear-cut statement. Also, when finalizing standards in 2024, I think that the decision should be made after reaching conclusions on each issue in the field tests and the various issues that have arisen thus far. In the current proposal, it is not clear when or how this will happen.

- When it comes time to actually introduce the new regulation, it is important to have a system in place that ensures that the design of the regulations works effectively, that is, from the perspective of proper application and operation. Regarding the validation framework, external verification is conducted in many countries under Solvency II regime in Europe, and its efficacy is also noted in a report from the EIOPA. Even if the calculation logic is valid, if the input assumptions and data are not correct, the result of the

calculations will be incorrect. Therefore, an independent third party is extremely important to ensuring validity. Going forward, when considering an independent third-party verification, a framework and reliable standards will be necessary, in addition to adequate resources. We should also note that this will likely require a certain amount of time.

- On page 9 of Material 1, it states that MOCE would not be deducted from required capital. Earlier, other members stated their opinion that this was reasonable. It is my opinion that MOCE should be calculated as a liability but that, if it is not deducted from required capital, then the MOCE portion will have to be further covered by eligible capital. I understand that the industry is asserting that there is an overlap in this. Personally, I think it would be good if this validity could be explained in a reasonable manner. Looking at the ICS, given the absence of an explanation regarding this, if we are going to do things the same as in the ICS, it would be best to clarify and discuss the basis for this. As for the choice of methodology, the percentile method appears to assess the volume of risk based on a single year. However, the average duration may differ depending on the insurance period of the products it possesses. I think there is room to discuss whether the percentile method properly reflects this or not.

- It appears that policy measures mentioned here are thought of as (potential) permanent measures, but it would be possible to use them as transitional measures, which could be studied through future field tests. In addition to the supervisory flexibility explained in page 13 in Material 1, one possibility would be to require notes in disclosure on the monetary impact of policy measures. When economic value-based figures are released they tend to be taken out of context. Regulated figures are sometimes used as a target of comparison. Through field tests, we need to carefully consider whether transitional or policy measures are necessary, taking into account how the market will react to the disclosed figures and whether it will lead to misconceptions.

- On page 7 of Material 1, it states that the domestic rule will have the same basic structure as the ICS. I understand this to mean that the ICS and domestic standards can be operated on the same computing system. Otherwise, different IT systems may be

required for each, which could be a significant burden.

- Regarding the necessary revisions to domestic regulations, I think it is best to carefully look at the differences that will arise between treatments on group- and solo-based regulations. For example, shares of subsidiaries are not included in the consolidated financial statements, but are reported on the asset side of solo-based financial statements. In other words, if ICS is adopted for solo-based regulation, items not assumed under ICS will be included in the asset side. Although this is a technical issue, discussion must be carried out on how this should be treated.

- It is good to calibrate risk factors based on historical data of domestic insurers. However, if a risk factor of 20% under ICS rules is deemed to have a factor of 10% under Japanese standards, it will be necessary to work on revising the ICS.

- On the timeline on page 2 of Document I, tasks are divided in various ways and it is useful for the industry for embarking on preparations. However, from 2020 to 2024, when standards are set to be finalized, I think it would be best to put a middle checkpoint at the interim of this four-year period. For example, it could be an idea to hold a meeting with experts at the interim point in 2022. In preparation for this, the process for organizing the remaining issues ahead of standardization should be made clear.

- I think the presentation of the timeline is a very important step forward. Owing to this, we can expect insurers to make the right preparations for achieving the vision. As stated by other members, it is important to ensure that insurers can smoothly transition to KPIs that suit an economic value-based regulation. I believe it is necessary to consider the issue of regulations for the real net assets as well as fundamental profit. Fundamental profit holds a high weight as a KPI for the management of life insurers, but such an approach is not consistent with an approach based on management fitting an economic value. For management, it is very easy to control fundamental profit in a way not reflecting the economic reality, for instance by leveraging the fact that forex cost is not reflected in the revenue from foreign bonds with hedging. I think revisions should be quickly made on fundamental profit.

- As described on page 10 of Material 1, consideration will be given to mutual companies, by allowing funds with a maturity of 10 years or more to be included in Tier 1 Limited. In cases where capital is assessed using a true economic value-based evaluation, hybrid capital is basically a combination of CDS (credit default swap) protection purchases and senior debt, regardless of whether it is a mutual company fund or subordinated debt. Thus the true contribution to capital in an economic value is merely the unrealized gain on CDS. When substantial progress is being made in the future with true economic value-based risk management, hybrid capital will not be included in eligible capital. In light of this, there is a possibility that the procurement of long-term hybrid capital in the near term could be a waste in the future (from the perspective of an economic value). To be clear, I am not opposed to the inclusion of hybrid capital in eligible capital. Rather, it can be theoretically asserted that the requirements for hybrid capital could be further relaxed from the perspective of an economic value. There is no need to have insurers issue debt with a maturity of ten years or longer and pay higher spreads in this low interest rate environment. In reality, it is necessary to procure a certain amount of hybrid capital including mutual company funds, to operate an economic value-based framework in a stable manner. Consequently, I believe that the requirements for capital eligibility conditions should be considered in the future.

- Discussions in Europe should constantly be carefully monitored. A key point is a level playing field. One example is the setting of an extrapolation starting point, where depth and liquidity in the bond market is the key point. In Europe, an extrapolation starting point of 20 years is being applied, even though the liquidity and depth of 30 year bonds outweigh those of 20 year bonds. At present, EIOPA is considering the extension as one of the options. Going forward, even if we design a system for Japan, we should implement an examination while monitoring the background of the developments in the US and Europe.

- Insurers are using economic value-based indicators in their internal risk management. They are also being used to verify the validity of dividends for mutual companies, which is made possible when the risk and the in-force value are aligned. Meanwhile, in field

tests conducted thus far, standardized risk factors are being applied, which makes it difficult to verify the validity of the levels of dividends. Under new regulations, an internal model is indispensable for enhancing policyholder dividends. The approval of an internal model requires considerable time and effort. I think consideration should be given to the introduction of risk factors based on historical data of each insurer to the standardized model.

- I think that the timeline needs to set aside a period to launch a working group during the preparation period. I think it is important to indicate the need for the participation of external experts and practitioners to proceed with the project.

- During the recovery period, we need to forecast when risks are likely to emerge going forward in this low interest rate environment. Even if risks are still 20 years or 30 years down the road, they will be calculated depending on the discount rate. This needs to be considered while deciding the recovery period.

- Insurers will not be convinced to use risk factors if they do not understand the basis for setting them. It is therefore essential to provide adequate background information to insurers.

- The purpose and need for validation of insurance liabilities need to be clarified. In addition to examples of methodologies, thought needs to be given to guaranteeing the qualifications of the individuals engaging in preparations and conducting verifications, and clarifying management's involvement in proving validity.

- As for MOCE, my opinion is that the risk margin could be properly evaluated whether it be the percentile method or the cost-of-capital method, as long as it is solid. As was pointed out earlier by other members, the percentile method of the ICS may not properly reflect the long duration of life insurers. I understand that the current specification in the ICS is a result of a tug of war between different opinions, including the one that MOCE should not be counted as an insurance liability but viewed as a margin. I think further discussion is necessary going forward.

- Whether a risk margin should be reflected into the value of insurance liabilities is an old discussion from many years ago. The IAIS has issued a cornerstone paper in the past, and the concept of economic value since then is to evaluate insurance contracts at transfer value rather than settlement value. The concept of transferability is also considered in the SCR (PCR) of Solvency II. In discussions conducted by this Council, if the PCR is employed as a basis, then including MOCE in liabilities is not particularly out of place.

- We have a desire to align regulations to the ICS as much as possible. However, if a final agreement cannot be reached on the ICS due to some policy or political reason, then as long as we have carried out our own discussion sufficiently, we should finalize the regulation in 2024, and start calculations in 2025 or 2026.

- If the introduction of economic value-based regulations could have a fair amount of impact on the market, I think it is necessary to urge insurers to make early preparations. If the introduction of the new regulation is conditional, there is a risk that companies aiming to introduce economic value-based KPIs are stuck with where they are. We need to think a bit more in advance about what we need to do to introduce economic value-based regulations. Without a policy in place to strongly encourage insurers to move forward, there will remain hesitation due to the difficulty and the impact, which could also trigger a delay in the improvement of risk management at insurance companies.

- Economic value-based regulation is crucial for Japan, and we need to agree on introduction in 2025. We need to cooperate with other countries to ensure we reach a final agreement on ICS in 2025. Should it become necessary, then we can make revisions as required.

- While the presented timeline is clear and easy to understand, my honest impression is that there is less time than anticipated. The schedule might be tight if we have to collect information from practitioners at insurance companies, discuss with them and decide on the details of the framework. In addition, I think we need to see what can be decided and presented by this Council.

- The timeline may be tight, but we have continually held discussions and have a sense of direction, though we need to decide on a slightly more concrete timeline. I personally believe that we can accomplish this by 2025. We have completed a fair amount of dry runs through several field tests so I think we are ready. Also, it may be good to stop calling it a “field test” and give it another name, to send a signal that progress is being made toward implementation.

- Although insurers have submitted figures for field tests, a substantial cost will be incurred when an actual regulation is in place, due to the issue of data governance and investments for various infrastructure. When to start the system development is a crucial problem. Methodologies and risk factors have repeatedly been changed thus far, so a large portion of the calculation procedure is carried out manually, although the situation could differ from company to company.

- The IAIS is planning to conduct an impact study in 2023. However, it might be better to conduct it a little earlier. A natural sequence of events would be to introduce the new regulation based on the results of the impact study if no material issue is identified. In light of this, it would be better to implement the impact study in 2022 or 2023 to check if there is no significant impact.

- In the current field test, it will be the first time insurers prepare a validation report on insurance liabilities. In doing so, they might have realized for the first time that there are shortcomings with governance and a need for systemization. It may not be the case that they are ready to prepare figures that could actually be disclosed, even though they have carried out calculations.

- I think that there is a difference between companies regarding the preparedness of calculation. Large companies may have a fair amount of resources, while small-and medium-sized companies may barely have the resources to meet the submission deadline. In addition, some will need to rely on external resources. The question is, just how much will small-and-medium-sized companies be expected to carry out on their own and by when. There are still many issues that need to be addressed before

implementation.

- The internal models used by insurance companies are becoming more systematized and it takes less time to calculate economic value-based figures. Meanwhile, we do not yet know whether the current specification of the field tests will be permanent. Consequently much of this process is being handled manually as of now. Until the standards are finalized, it is difficult to ascertain the right timing for making decisions, including on governance, personnel, and investment on IT systems. I believe that we need to closely monitor and determine the right timing and successfully proceed in line with the given timeline.

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